BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
GRANITE CONSTRUCTION COMPANY, INC.)

Appearances:

For Appellant: H. B. Scott, President and General Manager; H. F. Baker, Certified Public Accountant

For Respondent: -Burl D. Lack, Chief Counsel

O P I N I O N

This appeal is made pursuant to Section. 25667 of the Revenue and Taxation Code (formerly Section 25 of the Bank and Corporation Franchise Tax Act) from the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) on the protest of Granite Construction Company, Inc. to a proposed assessment of additional tax in the amount of $1,783.95 for the income year 1941.

On April 15, 1940, Appellant's majority shareholder loaned it $20,000 and Appellant issued its note to him in that amount. This sum was carried on Appellant's books in an account entitled "Notes Payable." On February 18, 1941, this shareholder, desiring to increase the assets of Appellant so as to benefit his two sons, who were to succeed to his interest in the business, and another shareholder offered to contribute the amount of the loan to Appellant. The minutes of a meeting of the Appellant's board of directors held on that date read as follows:

> "President W. J. Wilkinson then informed the Directors that he desired as of February 18, 1941 to make a contribution of the $20,000 loaned by him to the corporation during the early part of 1940, and upon motion duly made by H. B. Scott, seconded by J. E. Wilkinson and unanimously carried, it was moved to accept Mr. W. J. Wilkinson's contribution on behalf of the Company and include the same in its capital."

The sum of $20,000 was thereupon transferred on Appellant's books from the "Notes Payable" account to "Donated Surplus."

We are of the opinion that we must uphold the action of the Commissioner in regarding the transaction as involving a cancellation or forgiveness of indebtedness within the meaning of Section 6(d) of the Bank and Corporation Franchise Tax Act, as in effect during 1941, and, accordingly, as resulting in income of $20,000 to Appellant, no question having been raised as to Appellant's solvency prior to the transaction. A tracing of the statutory history of the cancellation of indebtedness provisions of the Act is of material assistance in ascertaining the intent of the legislature in this connection. Section 8(o), as added to the Act in 1937 (Stats. 1937, p. 2329) provided:

> "If a bank or corporation is allowed a deductionunder this section for an obligation and is subsequently discharged from liability therefor without having made full payment thereof, the amount of such obligation shall constitute income to the bank or corporation in the year in which the liability is discharged ..."

In 1939 Section 8(o) was repealed and replaced by Section 6(d) (Stats. 1939, p. 2938), the provisions of which read:

> "(d) If the indebtedness of a bank or corporation is canceled or forgiven in whole or in part without payment, the amount so canceled or forgiven shall constitute income to the extent the value of the property (including franchises) of the bank or corporation exceeds its liabilities immediately after the cancellation or forgiveness . . . ."

An additional paragraph, reading as follows, was added to Section 6(d) in 1945 (Stats, 1945, p.1787):

> "(2) If a stockholder of a bank or corporation cancels any indebtedness owing to the stockholder by the bank or corporation, such cancellation shall not constitute income to the bank or corporation except to the extent

> that the bank or corporation received a tax benefit under this act, from such indebtedness."

It is clear that the transaction in question would not have given rise to income under either the 1937 or the 1945 statutory provisions. The former came into play only when the discharge from liability related to an obligation for which a deduction from gross income had been allowed and the latter operated, in the case of a cancellation by a stockholder, only to the extent that the corporation had received a tax benefit from the indebtedness. The departure in 1939 from the tax benefit principle embodied in the 1937 law and the return in 1945 to that principle as respects indebtedness owing to a stockholder precludes, we believe, the acceptance as a matter of statutory construction (People v. Santa Fe Federal Savings and Loan Association, 28 Cal. 2d 675) of the Appellant's position that the existence of a tax benefit is essential to a finding of income in the instant case under the 1939 law. Such being the case, it necessarily follows that the&termination of this matter is dictated by McRoskey Mattress Co. v. Franchise Tax Board, 97 Cal. App. 2d 478, wherein the Court construed the 1939 version of Section 6(d). In fact, although a tax benefit had been enjoyed by the taxpayer in the McRoskey case, it is extremely doubtful whether the Court regarded that as material for it stated:

> "The statute is plain. Whenever the indebtedness of a bank or corporation is cancelled or forgiven by the creditor without payment, the amount so canceled or forgiven constitutes a taxable gain. The idea underlying the legislation is that by the event described the assets of the taxpayer are increased with exactly the same effect which results from income derived from any other source. The franchise tax is declared by the statute to be 'a tax according to or measured by' the corporation's net income. The net income is to be computed by taking from the gross income, as defined by section 6 of the act, all allowable deductions. Section 6, in defining gross income, includes by the terms of subsection (d) all gains from debt cancellation or forgiveness. There

> are no exceptions. Whenever and however the event occurs, liability for the tax arises." 97 Cal. App. 2d 478, 480.

All other arguments, except one relating to constitutionality, advanced by the Appellant and other taxpayers having appeals before us involving the 1939 amendment adding Section 6(d) to the Act are, in our opinion, answered by the McRoskey decision. Such arguments include the contentions that the transaction in question involved in reality not a cancellation or forgiveness of indebtedness but a gift or contribution of capital to the corporation and the contention that it is unreasonable to construe the statute as requiring the determination that income resulted to the taxpayer when a contrary result could have been reached, so it is asserted, by having the taxpayer pay the indebtedness and then having the stockholder return the same or other funds as a contribution of capital; The use of the more circuitous route of achieving the creditor's objective was expressly declared to be ineffective, and as respects the question of forgiveness versus gift the McRoskey opinion states:

> "The words 'without payment' as used in section 6(d) serve no purpose other than to emphasize the idea that cancellation or forgiveness, to result in a taxable gain, must be gratuitous - a gain for which no direct consideration passed from the taxpayer. Certainly there could be no forgiveness with payment." 97 Cal. App. 2d 478, 481.

It is also urged that Section 6(d) construed so as to uphold the action of the Commissioner herein is unconstitutional. As we have frequently indicated, however, it is our established practice to leave questions of constitutionality for judicial determination. See, e.g., Appeal of American Insurance Agency (June 18, 1943) and Appeal of Richfield Oil Corporation (March 2, 1950). Other adjustments made by the Commissioner have not been questioned by the Appellant and do not require consideration herein.

O R D E R

Pursuant to the view expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25668 of the Revenue and Taxation Code, that the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) on the protest of Granite Construction Company to a proposed assessment of additional tax in the amount of $1,783.95 for the income year 1941 be and the same is hereby sustained.

Done at-Sacramento, California, this 22d day of July, 1952, by the State Board of Equalization.

J. L. Seawell , Chairman

Geo. R. Reilly , Member

J. H. Quinn , Member

, Member

Thomas H. Kuchel , Member

ATTEST: Dixwell L. Pierce , Secretary